DECEMBER 1950

BUSINESS CONDITIONS

A REVIEW BY THE FEDERAL RESERVE BANK OF CHICAGO

Low Inventories Impede Production

But Most Trade Firms Have Ample Stocks

Total business inventories at the beginning of November were up a spectacular 2.8 billion from the previous month, having reached 58.8 billion dollars on a seasonally adjusted basis. The rise has continued in recent weeks, and inventories currently are well above the previous record level of 56.8 billion reached in late 1948. These impressive aggregate figures, however, do not tell the full story. How much of the increase in over-all inventories is a result of rising prices rather than larger physical volume? How does the inventory total compare with current levels of business activity? How adequate are manufacturers' stocks as compared with those of retailers and wholesalers? How well are goods distributed among individual firms?

Many manufacturers are finding their operations hampered by inadequate supplies of necessary materials, in contrast to trade firms which have built stocks to a point where holdings are well in line with current sales. Whereas producers of automobiles, freight cars, and machine tools report that production is limited by shortages of steel or other metal parts, merchants handling lines such as clothing, furniture, and in some cases major appliances are apprehensive of overstocking. This situation is not difficult to explain. During July and August stocks of finished goods moved from producers to dealers and consumers at a rate exceeding production. Since then, the scarcity of basic materials such as metals, chemicals, and natural rubber has prevented most processors from accumulating adequate inventories.

A proper evaluation of the current inventory position of business must, of course, be based upon a forecast of the level of business activity and sales. Unfortunately, the war situation makes the outlook extremely uncertain for the months immediately ahead. Few observers doubt that the large-scale defense expenditures planned for 1951 will exert severe pressure in the economy sometime next year. However, the belief is still voiced that Government controls over materials and private spending will cause some temporary cutbacks and unemployment early next year before the full weight of the increased armament program is felt. Aside from the uncertainty regarding consumer expenditures during the first quarter of 1951, a number of other important factors cloud the inventory picture, such as the probable effect of Government stockpiling operations and the priority orders of the National Production Authority.

AFTERMATH OF THE BUYING SPREE

Immediately after the start of the Korean war, business firms as well as housewives rushed to increase holdings of goods which were scarce during World War II. Most of the consumer "scare buying" during July and August was not based upon sound information. Soft goods such as sugar, soap, coffee, and white goods, which were purchased and stored away during the summer by hysterical persons, were actually in good supply. It was simply necessary to replace dealers' stocks which had been transferred to the nation's pantries and closets. Since September, automobiles and major appliances which were in such heavy demand during the buying spree have been readily obtainable.

Industrial hoarding has been a more serious matter because purchasing agents of firms which desired to stock up were better informed than the general public as to actual shortages. Increased purchases for inventory may be defended on the ground that management has a responsibility to attempt to maintain production schedules. In some instances, however, increased buying certainly has been of a speculative nature.

Within a few weeks after the start of increased business buying in June, loose stocks of scarce materials which could be purchased by processors were blotted up. Steel warehouses which had been inadequately supplied even before Korea were soon empty. This scramble for available supplies has resulted in some maldistribution of inventories. As a result, certain businessmen have advocated stronger Government controls in order to restrict unwarranted accumulations.

LARGER INVENTORIES AT HIGHER PRICES

Total business inventories increased 4.6 billion dollars or nine per cent from January 1 through September 30. During the month of September the total was rising at a rate of almost 22 billion dollars per year. Stocks held by retailers at the beginning of October totaled a record 15.7 billion dollars, 18 per cent above January 1. Almost all types of goods in the hands of retailers participated in the rise.

The increase in retail stocks in the third quarter was achieved, in part, by depleting the holdings of suppliers. After the phenomenal sales of the midsummer months, total department store stocks in the Seventh District on September 30 were almost 20 per cent above the level of the previous year. Only a portion of the increase could be traced to higher prices. At the end of September, District department stores, despite higher sales, had more than 2.8 months' supply of goods on hand. A year before only a 2.6 months' supply was held. Among the items showing the greatest increase relative to sales were blankets, underwear, and housewares.

The Department of Commerce estimates that about half of the 1.8 billion dollar rise in total business inven-

(*Continued on Page* 8)

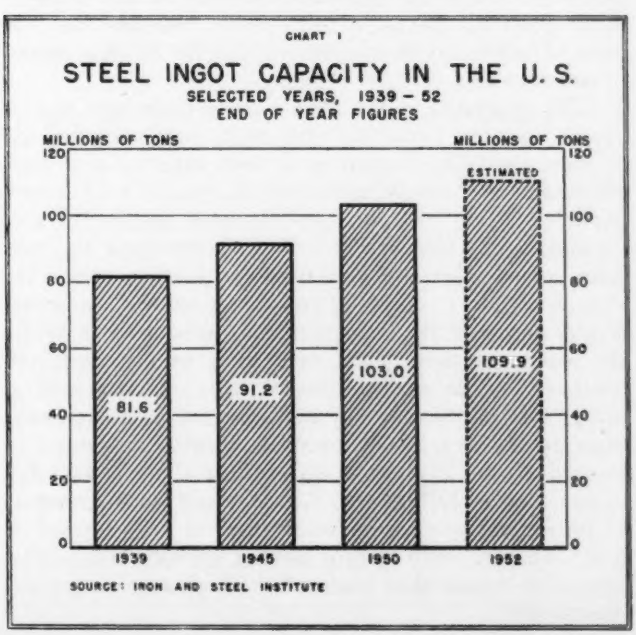
New Goals for Industrial Expansion

Defense Needs Spur Drive for More Capacity

A prominent military analyst[1], after studying our failures and successes in World War II, concluded that victory was achieved largely as a result of the weight of material our forces could bring to bear against the enemy. "After the factories of America achieved their tremendous output, no American general should have lost." Perhaps he overstates his case, but America's role as the "Arsenal of Democracy" was certainly a major factor in deciding the conflict.

Shortly after Pearl Harbor when President Roosevelt announced our initial goals of war production—which were reached and exceeded later on—Doctor Goebbels remarked in his diary that such figures made interesting "propaganda." If German and Japanese leaders had been fully aware of the speed with which our industry could turn from civilian goods to the production of overwhelming numbers of tanks, guns, planes, and ships, it is unlikely that the Axis powers would have declared war upon the United States. Now that full-scale war is a grim possibility once again, Governmental and business leaders are taking steps to strengthen America's greatest asset—the productive capacity of our factories.

Of course, wars are not fought with *potential* military strength. If full-scale war is considered probable within the next year, emphasis must be placed upon an immediate enlargement of our armed forces and upon equipping them fully with the latest weapons which can be turned out speedily. But if it is believed that all-out conflict will not result in the near future, we should endeavor to retain and increase our margin of superiority over the combined industrial might of Russia, her satellites, and the areas which she might easily overrun. Large stocks of war material accumulated before they are needed are likely to become obsolete and may lead to an unwarranted feeling of confidence.



A CONTRAST WITH 1940

Since the nature of modern warfare confers an advantage upon the side possessing the largest industrial capacity, current additions to plant and equipment increase military strength. Beyond this, we may find some comfort in the fact that this aspect of the defense program will bring long-run benefits to the nation once the emergency has ended. In contrast to World War II the new capital expenditures now in the planning stage generally will serve the dual purpose of increasing the stock of producers' goods which make possible a higher standard of living as well as preparing for war.

Most of the plants built specifically for the production of munitions and aircraft during the last war are standing idle and can be put into operation after renovation and retooling. In all, 450 Government plants were built during World War II. Half of these are not used at present, and most of the rest are in the "national industrial plant reserve" which means that they were sold or leased to private firms with the understanding that they would be kept in proper condition so that conversion to war goods could be accomplished within three months. The Government also holds about 150,000 machine tools in reserve.

The productive potential of American industry is far greater today that was true at the beginning of World War II, which came after a decade of lean years during which business concerns held new capital spending projects to a minimum. Since V-J Day about 85 billion dollars has been spent on new capital goods by business firms. These outlays plus the wartime expenditures have greatly increased worker productivity. New facilities combined with a larger labor force have probably increased the nation's productive potential by one-half during the past ten years. Nevertheless, basic shortages are confronted everywhere, and the situation does not call for complacency.

The great need today is for expansion of such basic industries as transportation, steel, electric power, and chemicals. Important programs for increasing capacity in each of these industries are now under way. If defense expenditures are held to the approximate amounts now contemplated, industry eventually will be able to provide for the higher production of material for the

[1]Hanson W. Baldwin, "We're Not the Best in the World," *Saturday Evening Post*, July 15, 1950.

armed forces without serious inroads on the present standard of living. That is the long-run picture. In the immediate future increased capital spending will result in restrictions on current living standards and will constitute a powerful inflationary force. These outlays not only add to the spending stream, but they cause materials to be diverted from the channels of consumption.

The grim possibility that atomic bombs may fall upon American cities has added impetus to the trend toward decentralization of industry which has been under way for years. Concentration of productive facilities in such metropolitan areas as Chicago, Detroit, and Pittsburgh offer excellent targets for enemy bombers. In order to decrease the dependence of the nation upon the factories of these cities as well as others of lesser importance, administration spokesmen have urged that whenever possible new factories should be placed in smaller towns or communities which are not highly industrialized.

ALL BUSINESS CATEGORIES PLAN NEW GROWTH

Since June industrial construction firms, machine tool builders, and related enterprises have been swamped with orders. As early as April and May it had become obvious that the original estimates of capital outlays for the year 1950 had been far too low. As general business measures moved upward after the start of the year, many executives decided that demand for their products justified further expansion and that it was useless to defer those plans which had been held back in anticipation of lower prices.

These reasons for pushing new plant and equipment outlays have been strongly reinforced since Korea. Never before has the conviction been so widespread (1) that a strong market, Governmental and private, will continue for many years to come, (2) that prices are almost certain to continue to rise, and (3) that many strategic materials will be in short supply. Added to these motives are the pressure from Government to expand certain types of business and the special incentives to embark on new capital expenditures which have been provided by Congress.

The Securities and Exchange Commission release on "Plant and Equipment Expenditures of U. S. Business" issued in December estimates the total for 1950 at 18.1 billion dollars, equal to the 18.1 billion recorded for 1949. This amount is up substantially from the estimate made earlier in the year, but is still probably too low. It is likely that the final total for 1950 will be second only to the 19.2 billion spent in 1948 and that a new record for capital spending will be established next year.

The Midwest appears to be more than holding its own in the drive for additional plant and equipment. Executives who must decide upon locations for new facilities continue to find this area attractive because of its advantages with regard to labor supply, transportation, and access to raw materials. The F. W. Dodge Company reports that construction contracts awarded for commercial, manufacturing, and public utility structures in an area approximating the Seventh District are well ahead of 1948 and almost double the total of a year ago. Industrial construction firms in Chicago and Detroit report that they have been unable to meet the great demand for their services. Numerous projects have been announced in recent months in such diverse fields as steel, baking, automobiles, clothing, chemicals, farm machinery, and electric power. A number of important nonessential undertakings such as suburban shopping centers have been proposed, but apparently these plans are being pushed slowly because of the fear that construction might be halted for lack of necessary materials.

Few of the capital spending projects announced so far this year can be traced directly to increased defense spending. However, a limited number of wartime factories in this area, including the mammoth "Dodge-Tucker" plant, are being reconverted so that they may be used to fill defense orders.

THE PROBLEM OF STEEL

Considerable controversy has been evoked by the pressure which the Government has exerted upon the steel companies to expand capacity well beyond present plans. The industry goal is 110 million tons of steel ingot capacity by the end of 1952 (see Table 1). Government economists have insisted that 120-125 million tons should be available by that time.

Robert E. Wilson, president of General Motors, recently declared that the steel industry has lacked faith in the continued growth and prosperity of the nation and that present expansion plans are too timid. His remarks were contradicted sharply by Edward L. Ryerson, chairman of Inland Steel. Since then, more than ever before, the adequacy of steel capacity has been the subject of editorials and talks by spokesmen for Government and industry. Edwin G. Nourse, former head of the Council of Economic Advisers, has termed the Government goals for industrial expansion "unreasonable" in view of the tight labor situation and the present extent of our resources.

The reluctance of the steel men to undertake greater capital spending programs than those now contemplated is understandable. Expansion of steel capacity is a complicated matter involving sources of ore and coke, transportation, blast furnaces, steel furnaces, and rolling and finishing mills. Ore will not be available from the new fields in Labrador and Venezuela for years to come, but even if adequate sources of supply are assured, construction of new steel facilities takes two years or more. While the plants are being built, steel must be diverted from other uses. Four million tons of steel are consumed in the process of constructing an additional 10 million tons capacity. There is also a question of risk. An increase of one ton of steel capacity is said to cost about $300 today compared with $80 prewar. Steel has long been known as a "prince and pauper" industry, since it has operated at peak capacity only during limited periods, whereas a depression means that much of the high cost equipment stands idle.

Critics of the steel industry's expansion policy point out that during the past decade the American economy has been continually hitting a ceiling determined by the amount of steel available, despite the fact that capacity has been raised from 81 million tons in 1939 to about 100 million tons today. We are still in the "iron age," and the amount of steel which can be turned out each year is an important determinant of both the effectiveness of our effort during a future war and the production of civilian goods in peace. The inadequacy of the steel industry's pre-Korea expansion program was tacitly admitted when plans for an additional five million tons of increased capacity were announced during the summer.

Since steel executives remain skeptical of expanding their plants at the rate considered desirable by administration spokesmen, President Truman has repeated a suggestion made several times in the past that the Government should undertake to build and operate new steel plants. This proposal has raised the cry of "socialism" and is bitterly opposed by the industry. However, if the needs of a semi-war economy require larger steel capacity, some answer to the problem must be found. Perhaps a compromise could be reached under which the steel companies would be assured of profitable operations for a term of years ahead, if they push expansion plans beyond present goals. Industry leaders have implied that the accelerated depreciation permitted under certain conditions by the new revenue act may stimulate the addition of new steel facilities.

OTHER BASIC INDUSTRIES PUSH EXPANSION

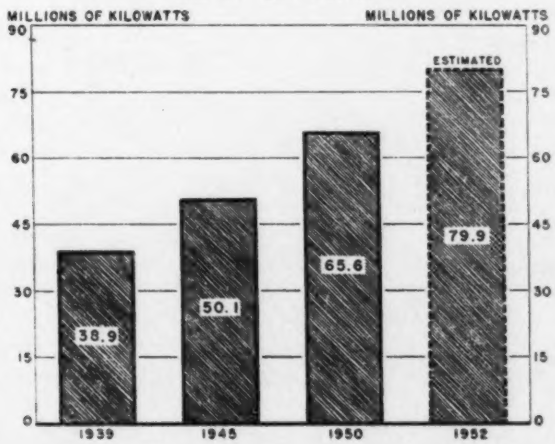
Aluminum—Statements of steel leaders concerning the adequacy of present and planned capacity are somewhat reminiscent of the assurances offered by aluminum company representatives in 1940 that any possible requirements of our Government or our allies could be satisfied without greatly expanding plant. Present capacity of the aluminum industry is 1.4 billion pounds, three and one-half times that of ten years ago. Nevertheless, W. Stuart Symington, chairman of the National Securities Resources Board, has expressed the belief that aluminum capacity should be raised as soon as possible by another two billion pounds, a program which would cost over one billion dollars. No loud protests from the industry have been heard up to this time.

CHART 2

ELECTRIC POWER CAPACITY IN THE U. S.

SELECTED YEARS, 1939—52

END OF YEAR FIGURES



SOURCE FEDERAL POWER COMMISSION.

Electric Power—Each year industry and consumers become more dependent upon electricity as a source of power and heat. At present, capacity is about 65 million kilowatts, an increase of one-third in the past five years. By the end of 1952 the electric power industry plans to have 80 million kilowatts available (see Table 2). The expansion program of the electric industry has been vigorous, but the prospect of war calls for an even greater effort. Two vital defense industries, aluminum and atomic energy, consume huge blocks of electric power. During World War II the reserves of power available from the Federal power projects on the Tennessee and Columbia rivers contributed significantly to the success of the aircraft production program and the atomic bomb project. Important amounts of unused power potential cannot easily be tapped today.

Transportation—The drive for additional freight cars has been goaded by persistent reports of stocks of goods piled on loading docks because cars are not available. A goal of 1,850,000 freight cars in good condition has been set by the Association of American Railroads. This total is only 120,000 more than the number now in use, but since cars are being scrapped at a rate of 6,000 a month, the objective will take at least three years to achieve and will cost over two billion dollars. At present, car makers are hampered by shortages of materials and skilled workers, but the National Production Authority intends to allocate 310,000 tons of steel per month to the freight car program, enough to make 10,000 freight cars. The backlog of freight cars on order has risen from less than 13,000 at the end of 1949 to 76,500 at the end of August.

Machine Tools—The machine tool industry has made spectacular gains in the past few months. This industry, which had been operating at only 50 per cent of capacity during the most prosperous periods of 1948, recorded new orders during August at a rate three times as great as in the average month of the 1945-47 period. Shipments of machine tools in September were double the January 1950 total, although production has not yet reached its peak because of shortages of skilled workmen and supplies.

AMPLE MONEY FOR NEW FACILITIES

Corporations will pay for most of their new expansion through retained earnings and depreciation reserves as they have during the earlier postwar period. Corporate profits before taxes reached an annual rate of 42 billion dollars during the third quarter of this year, a new record. Despite higher taxes and dividend payments, it is estimated that corporations are currently retaining

earnings at a record rate of 15.3 billion dollars per year. The other principal internal source of funds, depreciation reserves, will supply close to seven billion dollars this year—also a new high.

Corporations which desire to raise funds in the capital markets will be able to sell large quantities of bonds to life insurance companies, by far the most important purchasers of this type of obligation. While other types of savings were drawn down during the summer, life insurance made substantial gains. In September, sales totaled 2.3 billion dollars, a new record. At the same time the restrictions on residential mortgages are tending to cut down the supply of that important alternative outlet for new life insurance money.

Some part of the three billion dollar increase in business loans of weekly reporting banks since June is traceable to capital expansion. Strictly speaking, most banks do not lend money for the purpose of making important capital expenditures. However, as well-rated firms deplete cash reserves to finance new projects, they are likely to turn to commercial banks in order to correct this deficiency.

Apparently most business firms will not experience difficulty in obtaining funds for expansion, but to make certain that no necessary project is postponed because of inadequate financing, the Government recently has provided a number of special financial aids to business. The Defense Production Act of 1950 authorizes the Treasury to loan up to 600 million dollars to industrial firms "for the expansion of capacity, the development of technological processes, or the production of essential materials, including the exploration, development, and mining of strategic and critical minerals and materials." Money is also available from the Reconstruction Finance Corporation, which announced last July that it would henceforth make only those loans which would aid the national defense.

If the need arises, the Government doubtless will finance the building of new defense plants directly as it did during World War II. About three-fourths of the 23 billion dollars spent for defense plants between 1940 and 1945 was Government money. Half of all of the plants financed by the Government during World War II were owned by the War and Navy Departments and were operated by them directly or through private firms which received fees for their services. Most of the rest of the Government plants were financed by the Defense Plant Corporation and leased to the private concerns which operated them.

In contrast to this World War II experience, most firms probably will choose to do their own financing of new facilities. First, the over-all program is more modest when compared to existing capacity than was the case during World War II. Expenditures on capital goods from 1940-45 amounted to almost 40 per cent of the total book value investment in all manufacturing plants at the start of the war. Second, plants which are not adaptable to civilian production do not constitute a large proportion of the expansion now contemplated. Third, business leaders will be able to choose locations carefully and plan their expansion programs with an eye to the future. Finally, business is in a far better financial position today than in 1940.

Accelerated depreciation, another wartime device, has been resurrected to encourage private capital spending which will aid the defense effort. Firms wishing to write off new plant and equipment for tax purposes more quickly than is normally allowed by the Treasury Department may now do so under certain circumstances. If a new project is shown to be eligible, a "certificate of necessity" may be obtained from the National Security Resources Board which will permit facilities connected with the war effort to be depreciated in five years. Chairman Symington has stated that "consideration will be given to an over-all shortage, the necessity for an adequacy of facilities, material, or services for a particular region, the necessity for stand-by capacity, and other factors contributing to or threatening a shortage of facilities for producing such materials or services." Apparently steel and other basic industries will qualify for certificates. The program can also be used to encourage the spread of industry to areas less vulnerable to atomic attack.

Although many industrial leaders have been pressing for this sort of legislation for years, it is unlikely that accelerated depreciation by itself will bring much additional plant investment unless a heavy excess profits tax is enacted. Essentially, quicker write-offs merely allow a firm to concentrate tax deductions during the earlier years that an asset is held. The procedure is worth while only if the present allowable rate of depreciation overestimates the useful life of the object or if corporate tax rates are reduced after the item has been fully depreciated. Accelerated depreciation does not aid the firm which does not have and cannot obtain the funds necessary for expansion.

GUNS, BUTTER, AND INDUSTRY

If present capital spending plans proceed on schedule for the next two or three years, a substantial increase in the nation's industrial capacity will have been achieved. Although this prospect is encouraging, there is no justification for a feeling of security. At present Russia, with a much smaller industrial potential than ours, is reported to be far ahead in most types of armaments because a substantial portion of her total output has been diverted to this purpose during the entire postwar period. Success in another war will depend, in the last analysis, upon the quality and quantity of our weapons and the men who use them.

If all-out war should develop, a heavy burden would immediately be placed upon America's resources and manpower. This may occur long before the grand expansion plans of today have reached fruition. Our immediate concern must be an attempt to strike a balance between present and potential strength, between weapons and factories. No one can be certain what the proper allocation of resources should be, but the neglect of either aspect of the defense effort might have grave consequences for the national security.

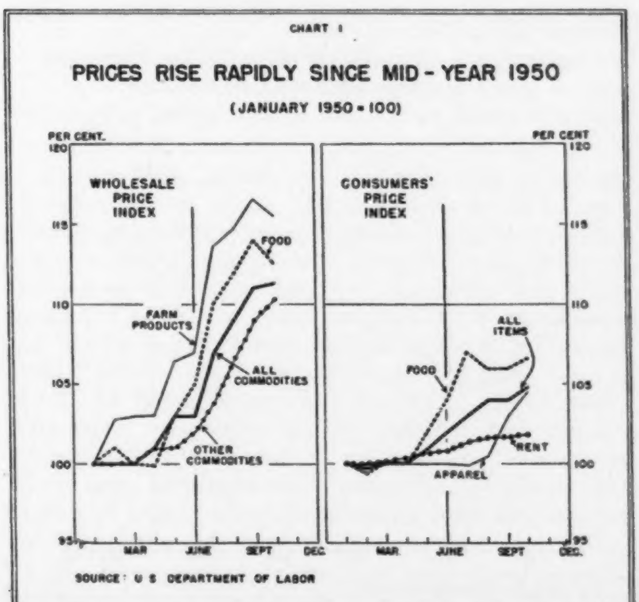
Price Indexes Pushed to New Highs

Basic Inflationary Pressures Presage Further Rise

Most wholesale and retail prices advanced to new all-time peaks in November. Previously there had been a dramatic surge upward during the late summer months of 1950, followed by a leveling off in the early part of October. The attainment of these record levels, together with the implications of the entrance of the Chinese Communists into the Korean conflict, indicate that inflationary pressures of increasing strength will confront the economy.

Prices had been moving upward for some months before the Korean conflict began. The U. S. Bureau of Labor Statistics Index of Wholesale Prices rose about four per cent during the first half of the year. Most of this increase occurred during May and June. In fact, price trends during this period aroused concern over inflation and further depreciation in the value of the dollar. For the first time in history a postwar recession had been halted after only minor adjustments. Fear of the postwar deflation, which had been forecast so frequently, was quickly replaced by apprehension over further price rises.

No group was more outspoken in voicing this apprehension than leaders of labor unions. Some workers are protected by cost-of-living clauses in their contracts, but this is not the usual case. After Korea it became apparent that there would be increased pressure on wage rates. Pension plans, which had occupied such an important place in labor-management negotiations earlier, assumed secondary importance as labor strove to maintain its real income. The success of these attempts to date has stemmed from one hard fact—workers are scarce.



Superimposed upon the general price rise which occurred during the first half of 1950 was the stepped-up increase which started in June. Except for the period immediately following the removal of price controls in 1946, the June-September 1950 rise in the general level of wholesale prices was the most abrupt since the end of World War I. The flood of business and consumer spending which resulted from increased international tensions slackened in the early fall, however, not only because of better news from the battle front, but also because anticipated shortages failed to appear.

The resulting reduction in demand lessened temporarily the pressure on prices. It is unlikely, however, that prices will continue the present relatively horizontal movement for long. The prospect of greatly increased arms spending by the government, on top of the already tight supply situation in the case of most goods, seems likely to result in further upward pressure on prices in the months ahead.

BASIC COMMODITIES LEAD THE PRICE RISE

Prices of raw materials rose further than those for any other type of goods during the first three quarters of 1950. Between the middle of June and the middle of September, prices rose eight per cent for sugar, almost ten per cent for steel scrap and copper, and more than thirty per cent for hides. These advances were important for several reasons. They indicated that great increases in demand for basic raw materials caused by "scare buying" could not be met immediately by corresponding increases in supply.

In addition, these price rises presaged increasing upward pressure on wholesale and consumer prices, since a large proportion of such price rises is passed on from producers at one level to those at the next. Finally, these increases in basic commodity prices stimulated speculation in the commodities affected. The spectacular advance of twenty-five per cent in the BLS Basic Commodities Index between June and September became so widely publicized that considerable attention was drawn to it. This emphasis helped to further the "inflationary psychology" of the economy and increased the difficulty of controlling inflationary pressures.

UPSURGE IN WHOLESALE PRICES

Wholesale prices, which began to rise immediately after the end of World War II, reached their peak in the third quarter of 1948, and then dropped during 1949 by about 11 per cent to a low in December. Since that time they have risen until many have equaled or exceeded the

record levels of 1948. The BLS Index of Wholesale Prices reached a record level of 169.5 in August of 1948 and in the middle of November 1950 broke through this former peak.

Between January and November of 1950, wholesale prices rose by about 11 per cent, much of which occurred between June and September (see Chart 1). The BLS Index of Wholesale Prices rose 6.1 points between December and June under the impetus of the construction boom, the record level of personal income bolstered by the GI insurance dividend, and the continued expansion of consumer credit. Between June and the middle of November, the index rose 13.8 points. The acceleration of the rise after Korea indicates that existing inflationary pressures were greatly intensified after the outbreak of hostilities.

During September and the first part of October, wholesale prices in general leveled off. This change took the form of a slackening of the rate of increase in basic commodity prices.

In many cases, so-called "administered" prices responded less vigorously to current inflationary pressures than did so-called "free" prices. Some producers, who had control over the prices of their products, did not permit increases. In addition, it takes time for the pressure resulting from price increases of basic commodities to be transmitted to the retail level. However, in the period immediately following Korea, some producers felt constrained to increase prices of selected items in an attempt to protect themselves against the possibility of price controls. Price increases resulting from this action, however, have caused only a relatively small part of the general price rise.

CONSUMER PRICES REACH NEW PEAK

Consumer prices rose less during the first three quarters of 1950 than wholesale or basic commodity prices, but indications are that greater increases will occur. Increases at the wholesale level which have occurred since the first of the year, especially since June, have placed mounting upward pressure upon prices paid by consumers. Hence, the full results of price rises in commodities at wholesale, which took place during late summer, have yet to be felt. Resistance on the part of consumers to price rises may postpone, but does not prevent, consumer price increases.

Despite the fact that consumer price changes have lagged behind those of wholesale prices, the two categories have experienced essentially the same trend since the summer of 1948. From a high of 174.5 in August and September of 1948, the BLS Consumer Price Index fell to a low of 166.5 in February of 1950. By October, however, after pausing during September, it had risen to 174.8, a new postwar peak. It is quite likely that the November figures will be even higher. The total rise between January and October 1950 amounted to almost five per cent. The index rose approximately two per cent the first half of the year and three per cent between June and October.

Although all components of the consumer price index rose during the first 10 months of 1950, some advanced substantially more than others. Food prices, which increased slightly more than seven per cent, showed the greatest change. Rents, on the other hand, protected to a great extent by controls, increased only a little over one per cent.

WHY DID PRICES RISE?

The rise in prices which has occurred since the beginning of 1950 has been caused by several factors. In the first place, expenditures by consumers, businesses, and Government generally were at very high levels. In particular, industrial plant and equipment outlays were large and rising, residential construction was at an all-time high, and the NSLI dividend had buoyed up consumer expenditures.

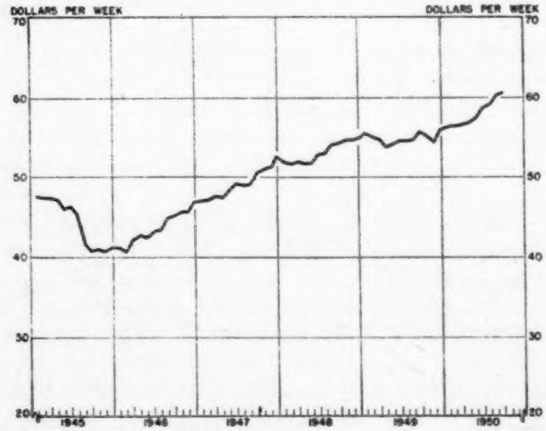
Second, the pressure brought by organized labor for higher wages has undoubtedly increased already existing inflationary pressures. This conclusion is justified whether such wage increases are passed on directly or not. If the increased costs resulting from increased wage payments are passed on to the consumer in the form of increased prices, the result is direct and obvious. Even if these costs are not passed on in this manner, workers receiving additional wages have more spending power than before. Unless this increase is accompanied by more production, the result is greater inflationary pressure.

Third, during the first 10 months of 1950 total instalment credit increased over two and a half billion dollars. Since the purpose of this type of credit is to facilitate purchases of consumer goods, durable goods in particular, such an increase indicates an additional demand for such goods. As might be expected, the demand for consumer durables increased more during the first nine months of the year than the demand for nondurables.

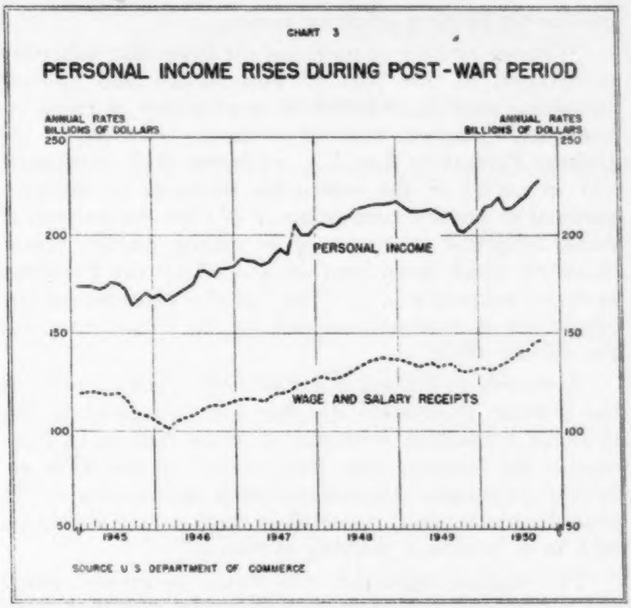
Fourth, governmental stockpiling activities have in

CHART 2

AVERAGE WEEKLY EARNINGS OF INDUSTRIAL WORKERS IN ALL MANUFACTURING INDUSTRIES



SOURCE: U. S. DEPARTMENT OF LABOR



some areas placed additional pressures on prices.

Finally, and most important as a cause of the accelerated rise in prices after Korea, was the scare buying by consumers and businesses. Many individuals and businesses reacted to the outbreak of hostilities by rushing to buy goods which they feared might become unobtainable or which might experience a significant increase in price. These purchases were financed in part by growth of bank credit and by some liquidation of past savings.

WAGE PAYMENTS INCREASE

An inquiry into wage developments is basic to a complete analysis of the implications of price changes. Wages are a fundamental element of the price structure, as they are the "price" which labor as a group receives for its services. To the extent that wages move upward with increases in the cost of living, they offset for the wage-earning group some of the current effects of a "declining value of the dollar."

During 1950, as the cost of living rose, unions increased emphasis upon contracts which provided cost-of-living adjustments in hourly rates. The General Motors contract of 1948 served as a guide for many of these agreements. In essence, this contract provides that hourly wage rates of General Motors workers are to be adjusted periodically in accord with changes in the BLS "cost-of-living" index. Even where unions did not show any desire to tie hourly wage rates directly to the consumer price index, pressure for special "cost-of-living" increases mounted. Partly because of an increasing scarcity of labor, large employers were unusually compliant. The success of union workers in obtaining these increases encourages similar raises for nonunion workers.

The latest example of the price-wage spiral occurred at the end of November. At that time, the BLS Consumer Price Index had risen enough to bring about another three cent per hour increase in the wages of over 600,000 workers covered by UAW-CIO contracts containing escalator clauses. Based upon the rise in the index, the U. S. Steel Corporation granted approximately 165,000 members of the CIO United Steel Workers Union wage increases averaging 16 cents per hour. This was an 11 per cent rise and represented the "fifth round" of such increases. Bethlehem and Republic Steel Companies followed suit almost immediately with similar increases, and it appeared likely that the rest of the steel industry would do the same within a short time. Undoubtedly, the automobile industry, a large proportion of the workers of which are also covered by escalator clauses, will find it difficult to resist further wage increases.

Soon after the announcement of the wage advances, spokesmen for the U. S. Steel Corporation announced a rise of three-tenths per pound in the price of its products. This rise put further pressure upon steel prices in general and upon the products made therefrom. Partly as a result of this rise in the price of steel and of costs of production in general, several large automobile manufacturers announced early in December that they were planning to advance the prices of their 1951 models. The relatively small extent of the rise did little to allay fears of further inflation.

As a result of these higher hourly wage rates and the concurrent increase in the number of hours worked, average weekly earnings in all manufacturing industries increased 10 per cent between January and October. Since the BLS Consumer Price Index rose only about five per cent during the same period, it appears that during the first 10 months of 1950 average real earnings of workers in industry improved slightly. The increase in income tax rates in October, however, offset in part this increase in real wages.

Workers in some industries fared better than others. Average weekly earnings in the lumber and wood products industry increased over 20 per cent during the first 10 months of 1950, while corresponding earnings in the electrical machinery industry rose only about five per cent. Moreover, advances in the cost of living were not uniform within all areas of the United States.

INFLATIONARY PRESSURES TO CONTINUE STRONG

With Communist China entering the Korean conflict, the expected step-up in defense expenditures will boost the upward pressure on prices. Effects of the increases in already high incomes which the program is sure to generate will be aggravated by cutbacks in civilian production. Moreover, past savings in the form of Government securities, bank deposits, and cash can be used to augment current spending if the inflationary psychology of the economy grows stronger.

Inflationary pressures more intense than any experienced thus far during the postwar period are imminent. We face the hard fact, therefore, that anti-inflationary measures significantly stronger than those employed during the past five years must be utilized if the incipient rise in prices is to be held within tolerable limits.

LOW INVENTORIES IMPEDE PRODUCTION

(Continued from Inside Front Cover)

tories during September was a result of higher prices. This estimate, however, admittedly is very rough. The Purchasing Agents Association of Chicago reported at the end of October that 80 per cent of its members held the same or smaller physical inventories than was the case a month earlier, continuing a trend in evidence since May.

There is a wide variation in the adequacy of business inventories among particular lines. Some of the items in short supply which are badly needed by manufacturers have already been mentioned, but statements concerning the over-all categories do not point up the more urgent specific problem cases such as cold rolled steel, sulphur-based chemicals, and electrical components containing cobalt. Shortages of these critical items already have caused layoffs in some factories.

In the retailing field the picture is quite different. Stocks of many soft goods are so large that price-cutting sales may be necessary in January. Some merchants are currently concerned about large holdings of consumers durable goods. Production of such major appliances as refrigerators and washing machines has been heavy for most of the year, and output continued at higher than seasonal rates during the summer. There has been some apprehension over the number of television sets now on hand. The letdown in sales of the above items has been laid to anticipatory buying in the months immediately following Korea, the impact of more stringent consumer credit terms, and in the case of television, the possible introduction of color and the imposition of the manufacturers' excise tax.

There are signs in this area that new orders for consumer goods have been trending downward in recent weeks. This development stems from a number of factors: (1) retail sales in October and November were only moderately above those of the previous year; (2) inventories in some retail lines are more than adequate; and (3) supplies of certain items are not available because of the growing number of priority orders. Most purchasing agents, however, find that they must buy 90 days or more ahead to be sure of deliveries.

INVENTORY ACCUMULATION AIDS INFLATION

Growing inventories account for a substantial part of the 25 per cent rise in business loans between June 28 and November 15. Although the rate of increase has slackened recently, commercial and industrial loans are still rising rapidly.

Some banking opinion holds that the increase in business loans is a result, not a cause, of inflation and that higher prices and higher levels of activity require a larger volume of loans. Although there can be no doubt that adequate bank credit to finance production is more necessary today than ever before, it is nevertheless true that additional lending increases the money supply and creates new spending power. Most bankers try to discourage loans which might encourage speculation or the holding of excess stocks.

Without entirely abandoning the hope that voluntary moderation on the part of businessmen and bankers would mitigate the inflationary implications of rising inventories, Congress included inventory controls in the Defense Production Act: "... no person shall accumulate (1) in excess of the reasonable demands of business, personal or home consumption or (2) for the purpose of resale at prices in excess of prevailing market prices, materials which have been designated by the President as scarce materials . . . ." The Act also provides for the requisition of materials needed by the Government for the defense effort.

Authority to enforce the inventory control section of the Defense Production Act has been delegated to the National Production Authority of which William H. Harrison is the administrator. Regulation I of the NPA, effective September 18, ordered that inventories of 32 enumerated classes of materials in short supply should be held to a "practical working minimum."

The original regulation was stated in general terms and did not call for reports of inventories or orders. Specific requirements are being added, however, as priority and allocation orders are issued by the NPA. Orders issued so far have been concerned with a large group of scarce commodities such as caustic soda, chlorine, steel, aluminum, zinc, packaging materials, and natural rubber. Most of these commodities are being accumulated in Government stockpiles which tends to aggravate the problems involved.

INVENTORY POLICY IN THE MONTHS AHEAD

Manufacturing firms are continuing to attempt to bring their inventories up to the levels required for efficient operations. At the end of September 1950 total business inventories were 1.29 times sales, compared with a ratio of 1.43 a year before. For manufacturing firms these ratios were 1.42 and 1.64, for retailing, 1.29 and 1.31. During October and November total business stocks increased relative to sales.

It is apparent that manufacturers' inventories are low relative to the present level of business activity. In retailing, the supply of certain items may justify apprehension, but nowhere are important inventory losses in prospect. Most of the goods now in over-ample supply could be swept from the shelves in a new buying surge which might occur if the public becomes concerned about the drastic cutbacks in certain types of production planned for the coming year.

Some concern has been voiced over the prospect of lower sales and profits for manufacturing firms which have been or will be forced to reduce operations because of materials shortages. Some dislocations are a certainty, but no important downturn in business can be forecast in a semi-war economy. With the exception of items entering Government stockpiles, these commodities are being used *somewhere*. Shortages are merely a symptom that business activity is continuing at an extremely high level.

Business Conditions

A Review by the Federal Reserve Bank of Chicago

INDEX FOR THE YEAR 1950

SEVENTH FEDERAL

RESERVE DISTRICT